IN THE

Supreme Court of the United States

October Term, 1977

No. 77-918

The First National Bank of Glen Head,

Petitioner,

v.

Donald Katz, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Michael L. Cook
Attorney for Petitioner
767 Fifth Avenue
New York, New York 10022
(212) 758-7800

Lawrence Mittman,
Weil, Gotshal & Manges,
Of Counsel.

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The First National Bank of Glen Head (the "Bank"), the petitioner herein, seeks the issuance of a writ of certiorari to the United States Court of Appeals for the Second Circuit (the "Second Circuit"), reviewing that court's judgment and opinion entered on October 17, 1977.

Opinions Below

The opinion of the Second Circuit, not yet officially reported, appears in Appendix I annexed hereto. The opinion of the United States District Court for the Eastern District of New York, dated October 19, 1976, is officially reported at 424 F.Supp. 1174, and a copy thereof is annexed hereto as Appendix II.*

Jurisdiction

The judgment of the Second Circuit was entered on October 17, 1977, and this petition was filed within 90 days of that date. The Court has jurisdiction pursuant to 28 U.S.C. §1254(1) and Section 24c of the Bankruptcy Act (hereinafter referred to as the "Act"), 11 U.S.C. §47(c).

Questions Presented

1. Whether a unilateral decision by an allegedly insolvent corporate depositor not to exercise its right to draw checks against its general, unrestricted checking account transforms the depository bank, without its knowledge, from a debtor of the depositor to a transferee within the meaning of Section 60a of the Bankruptcy Act, 11 U.S.C. §96(a).

2. Whether deposits to a general unrestricted checking account made by a corporate depositor within four months of bankruptcy are transfers under Section 60a of the Act,

* References to the annexed appendices will be designated "App."

11 U.S.C. §96(a), where there is no showing of fraud or collusion between the depositor and the depository bank aimed at creating a preferential transfer of the depositor's property.

3. Whether a trustee in bankruptcy opposing a motion for summary judgment may rest upon the mere allegations of his pleading, without setting forth specific facts showing that there is a genuine issue for trial.

Statutes and Rules Involved

Section 60a(1) of the Bankruptcy Act, 11 U.S.C. §96(a)(1):

> "§60. *Preferred Creditors.*
>
> *a. (1)* A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

Section 60b of the Bankruptcy Act, 11 U.S.C. §96(b):

> "b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property,

except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value...."

Section 68a of the Bankruptcy Act, 11 U.S.C. §108(a):

"*§68. Set-Offs and Counterclaims.*

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

Rule 56(e) of the Federal Rules of Civil Procedure:

"*(e) Form of Affidavits; Further Testimony; Defense Required.*

Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him."

Statement of the Case*

On or about January 16, 1969, in consideration of a loan from the Bank in the amount of $125,000, Oakland Foundry of Belleville, Illinois ("Oakland" or the "bankrupt") executed a promissory note in favor of the Bank for the sum of $125,000. The promissory note was later made payable on demand on June 18, 1977. Oakland's indebtedness to the Bank was guaranteed by its president, Herman W. Brede ("Brede"), his wife, Bette D. Brede, and by Electronics Cabinets, Inc., a corporation whose stock was owned by Brede.

At the time of the Bank loan to Oakland, Oakland opened a general checking account with the Bank (the "Glen Head Account"), and there were no restrictions on Oakland's right to make withdrawals. Oakland also maintained another account at the St. Clair National Bank of Belleville, Illinois (the "St. Clair Account").

From the inception of the loan, Oakland deposited its funds into the Glen Head Account and the St. Clair Account. From January 6, 1970 until April 15, 1971, "at least 260 checks" were drawn on the Glen Head Account. Oakland made deposits to the Glen Head Account aggregating $47,738.56 during the month of April, 1971, $48,105.05 in May of 1971, and $12,075.21 in June of 1971.

On or about June 29, 1971, Brede, as Oakland's president, called Anthony D. Famighetti ("Famighetti"), then president of the Bank, and told him that Oakland was in

* The facts are distilled from the opinions of the lower courts, and those set forth herein are undisputed.

"financial trouble." As a result of this conversation, on June 30, 1971, the Bank set off the amount on deposit in the Glen Head Account, aggregating $108,783.91, against Oakland's original indebtedness of $125,000. Brede and Famighetti, without contradiction, later confirmed under oath their conversation on June 29, 1971, and that there had been no prior communications between Oakland, Brede and the Bank relating to Oakland's financial problems. No evidence to the contrary has ever been offered by the plaintiff-respondent.

On July 15, 1971, an involuntary petition in bankruptcy was filed against Oakland in the United States District Court for the Eastern District of Illinois. Oakland was subsequently adjudged bankrupt on August 18, 1971, and Donald Katz, the respondent (hereinafter referred to as the "Trustee"), was appointed trustee in bankruptcy for the Oakland estate on October 12, 1971.

On July 13, 1973 the Trustee filed a complaint in the United States District Court for the Eastern District of New York, alleging that the Bank received a preferential transfer from Oakland in the aggregate sum of $108,732.07, which was purportedly voidable under Section 60b of the Act. No other claim for relief was made, and the jurisdiction of the district court was invoked under Sections 23 and 60b of the Act. In essence, the Trustee claimed that Oakland's deposits made during the four-month period preceding bankruptcy "were not made or accepted in the regular course of [the Bank's] business or in good faith," and that the Bank's set-off on June 30, 1971 was thus improper.

The district court found that the Trustee's allegations were without foundation in fact because "there [was] nothing in the record by which the trustee could establish on a trial that these deposits were received by the Bank in anything other than its ordinary course of business." Accordingly, the district court granted the Bank's motion for summary judgment dismissing the complaint, holding that "the bank had a right of set-off and its exercise thereof did not constitute a voidable preference."

A divided panel of the Second Circuit, made up of one Circuit Judge and one District Judge sitting by designation, held "that the legal standard articulated by the district court was erroneous" and reversed the district court's judgment. According to the majority opinion, "[i]f a depositor fully intends to leave the deposits in the account, available for set-off, they constitute payments on account of an antecedent debt whether or not at the time the deposits are made the bank knows it." App. I, at 5, 10. As noted by the dissenting Circuit Judge, the majority thus held that "a unilateral decision by a depositor not to exercise his right to draw checks against his account transforms the bank, without its knowledge, from a debtor to a transferee." App. I, at 12.

The dissenting opinion also noted the "long run" effect of the majority's decision on all financially troubled businesses. Because the "businessman seeking credit is most likely to secure it at the bank where he is a depositor," and "because the right to set-off encourages [the bank] to continue credit when it might be induced otherwise to call its loans," the majority's opinion removes "[the] inducement for the bank to work along with the financially troubled entrepreneur." According to the dissent, Congress wanted

to encourage such cooperation from banks when it preserved the bank's right of set-off in the Chandler Act amendments to the Act in 1938, and such a right should not be judicially eliminated. App. I, at 16.

REASONS FOR GRANTING THE WRIT

I

The decision below conflicts with a prior decision of this Court.

The basic issue before the Second Circuit and the district court was whether the bankrupt made a transfer under §60a of the Act. On its motion for summary judgment in the district court, the Bank noted that the Trustee had failed to make out a *prima facie* case because he had failed to show, among other things, insolvency at all material times or that Oakland had made a transfer of its property. "For purposes of . . . [the Bank's] motion," the district court merely "assumed . . . Oakland was insolvent and that the bank had reasonable grounds to believe that Oakland was insolvent." App. II at 21.

A. Oakland made no transfer of its property within the meaning of Section 60 of the Act.

The holding of the court below that Oakland's deposits in the Bank were "transfers" under Section 60 of the Act directly conflicts with this Court's often-cited holding in *New York County Nat'l Bank* v. *Massey,* 192 U.S. 138 (1904). In that case, this Court held that deposits in a bank are not "transfers" under Section 60 of the Act, where no

"fraud or collusion between the bankrupt and the bank" has been shown. 192 U.S. at 148. Thus, because "one of the elements of a preference enumerate in §60a is wanting [here], . . . a preference under the terms of §60 . . . has not been established." 3 Collier, Bankruptcy ¶60.02, at 758-60 (14th rev. ed. 1976).

In *Massey,* the plaintiff trustee in bankruptcy claimed that the defendant bank had received a preference when it set off its insolvent depositor's funds. Prior to the set-off, the bankrupts had asked the defendant bank to extend the maturity of its loan to them, saying that "they were unable to pay the notes then about to fall due." 192 U.S. at 142-43. The bankrupts were two individuals doing business as a partnership who were indebted to the defendant bank for the sum of $40,000, evidenced by four promissorry notes of $10,000 each. Although their business was known as "Stege & Brother," the business was apparently primarily liable on the notes to the defendant bank. Under traditional principles of partnership law, the individuals would be liable to the bank if the business was unable to repay the loans. *See* MacLachlan, Bankruptcy §356, at 425 (1956) ("Since under the entity theory the partner is still liable upon the firm debts, his position becomes like that of a surety."). It was undisputed that the bankrupts were insolvent when they deposited more than $6,000 in their account at the bank within four days of bankruptcy. After the bankruptcy adjudication, the bank claimed the full amount of its debt less the amount on deposit, which it had applied as a set-off against the outstanding indebtedness. The trustee in bankruptcy thereafter moved in the bankruptcy court for an order disallowing the bank's claim unless it surrendered

the amount of the deposits credited by the bank against the outstanding loans of the bankrupts. The Second Circuit reversed the order of the district court allowing the bank's claim, and held that the deposits were transfers, enabling the bank to obtain a greater percentage of its debt than creditors of the same class, and that allowance of the bank's claim should be refused unless the preference was surrendered. 192 U.S. at 144.

This Court reversed the Second Circuit's holding that the deposits were transfers, but accepted the findings that "the deposits were made in the usual course of business," and that "at the time they were made [the bankrupts] were insolvent," reasoning as follows:

> "It is true that the findings of fact in this case establish that at the time these deposits were made the assets of the depositors were considerably less than their liabilities, and that they were insolvent, but there is nothing in the findings to show that the deposit created other than the ordinary relation between the bank and its depositor."

192 U.S. at 145. The Court went on to explain why a deposit of money to one's credit in a bank does not diminish the depositor's estate:

> "[A] deposit of money to one's credit in a bank does not operate to diminish the estate of the depositor, for when he parts with the money he creates at the same time, on the part of the bank, an obligation to pay the amount of the deposit as soon as the depositor may see fit to draw a check against it. It is not a transfer of property as a payment, pledge, mortgage, gift or security. It is true that it creates a debt, which, if the creditor may set it off under §68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are not in the same situation, and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preferences so as to prevent set-off in cases coming within the terms of §68a. If this argument were to prevail, it would in cases of insolvency defeat the right of set-off recognized and enforced in the law, as every creditor of the bankrupt holding a claim against the estate subject to reduction to the full amount of a debt due the bankrupt receives a preference in the fact that, to the extent of the set-off, he is paid in full."
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> ". . . It is true, as we have seen, that in a sense the bank is permitted to obtain a greater percentage of its claim against the bankrupt than other creditors of the same class, but this indirect result is not brought about by the transfer of property within the meaning of the law. *There is nothing in the findings to show fraud or collusion between the bankrupt and the bank with a view to create a preferential transfer of the bankrupt's property to the bank, and in the absence of such showing we cannot regard the deposit as having other effect than to create a debt to the bankrupt, and not a diminution of his estate.*"

192 U.S. at 147-48. [Emphasis added.] This Court's reasoning in *Massey, supra,* demonstrates that the Bank's obtaining a greater percentage on its claim than other creditors does not make the Bank's set-off voidable. Moreover, as proof that there was no transfer of the funds deposited in the Glen Head Account, any judgment creditor of Oakland could have enforced its judgment against the Glen

Head Account prior to the set-off on June 30, 1971. New York Civil Practice Law and Rules §5232(a).* Under this Court's analysis in *Massey,* therefore, the deposits from Oakland could not be deemed a transfer, as would a "payment, pledge, mortgage, gift or security."

As stated in *Massey,* for there to be a transfer, there must be "fraud or collusion between the bankrupt and the bank with a view to creat[ing] a preferential transfer of the bankrupt's property to the bank." Nevertheless, the Second Circuit disregarded the "fraud or collusion" requirement by holding that the bankrupt's subjective intention to transfer, without more, is sufficient.** As noted by the dissent, the Second Circuit's majority opinion conflicted with the holding in *Massey, supra,* that there be some participation or understanding on the part of the bank before an ordinary deposit can be considered a transfer. App. I, 15.

The district court properly summarized the record here as follows:

> "There is nothing to show that the bank engaged in any collusion with Brede or Oakland, that it in any way isolated or liened the funds in Oakland's checking

* The relevant portion of which reads as follows:

> "The person served with the execution [of the judgment creditor] shall forthwith transfer all such property . . . to the sheriff. . . . Until such transfer or payment is made, . . . the garnishee [i.e., the bank] is forbidden to make or suffer any . . . transfer of, or any interference with, any such property. . . ."

** The word "collusion" has been defined to mean "an agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law." Black's Law Dictionary, at 331 (1968 rev. ed.).

> account, or treated the transactions in any way different from any other general checking account. . . .
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> "Such action by the depositor alone is not enough to constitute a voidable preference. The test is not whether the deposits were made in the depositor's regular course of business, but instead, whether they were accepted by the bank in its regular course of business. Viewed in that light, there is nothing in the record by which the trustee could establish on a trial that these deposits were received by the bank in anything other than its ordinary course of business. The funds were kept available in the checking account, ready to be withdrawn anytime up until the right of set-off was exercised."

App. II at 24-25; 424 F. Supp. at 1177-78. The Trustee has never offered any evidence to show that the Bank received Oakland's deposits in other than the regular course of its business. Without pointing to any factual basis, the Second Circuit inexplicably accepted the Trustee's bald allegation that the Bank accepted Oakland's deposits outside of the ordinary course of its business.

There is also nothing in the record which even tends to show collusion between Oakland and the Bank for the purpose of making a preferential transfer of Oakland's property or for any other purpose. Indeed, it is undisputed that a debtor-creditor relationship existed between the Bank and Oakland, enabling Oakland to withdraw funds from the Glen Head Account at will. *See* App. II, at 19. ("The Glen Head account was a general account, and there were no restrictions on Oakland's right to make withdrawals."). In short, the Second Circuit disregarded this

Court's holding in *Massey*, and held that a wholly innocent bank can be held liable in a voidable preference action, a result which Congress never intended.

B. The commentators confirm the vitality of this Court's rule in *Massey*.

Set-off in bankruptcy and reorganization cases is still of vital concern to the business community, as noted by the commentators:

> "The Bankruptcy Act is, in a sense, a part of every business and commercial contract and relationship and there is general pragmatic recognition of its influence in the area of setoffs as is evidenced by the widespread requirement of commercial banks for the maintenance of compensating balances by business borrowers."

Morton, "Creditor Setoffs in Business Reorganization and Relief Cases Under the Bankruptcy Act," 50 Am. Bankr. L.J. 373, 387 (1976); *see also* Justman, "Comments on the Bank's Right of Setoff Under the Proposed Bankruptcy Act of 1973," 31 Bus. Law. 1607 (1976).

This Court's decision in *Massey, supra,* is still recognized as the "leading case on the subject" of the bank's right of set-off. Hanna & MacLachlan, Creditors' Rights and Corporate Reorganization, at 922 (5th ed. 1957); Riesenfeld, Creditors' Remedies and Debtors' Protection, at 667 (2d ed. 1975). Perhaps the most concise statement of the applicable law is contained in the leading bankruptcy treatise:

> "Here we are concerned with the right of a creditor bank to offset against its claim deposits made by an

> insolvent depositor within four months of bankruptcy. Within certain limitations, hereinafter elaborated, such a transaction has been held not to create a voidable preference within the meaning of §60, even though the result is that the bank fares better than other creditors of the bankrupt not similarly situated. The general rule may first be stated that where an insolvent depositor makes general deposits within four months of his bankruptcy, *which deposits are accepted in good faith and in the regular course of business,* the bank has a right to set off such deposits against an obligation owing to it by the depositor. Obviously, where the bank has no knowledge or imputation of knowledge, or 'reasonable cause to believe,' that the depositor is insolvent, such routine deposits are clearly available as set-offs. But even though the depositor was insolvent and knowledge of this fact could be charged against the bank at the time when the deposit was made, the bank is still entitled to apply the deposit on its claim, *so long as it was accepted in good faith, in the ordinary course of business.* It is only where affairs have reached such a point that the bank accepts the deposit for the purpose of payment, or of giving itself a subsequent advantage over other creditors through its right of set-off, or for some other special purpose, that the deposit and the subsequent application of it amounts to a recoverable preference."

4 Collier, Bankruptcy ¶68.16, at 915-920.1 (14th rev. ed. 1975). [emphasis added.]

Thus, the commentators interpreting this Court's decision in *Massey, supra,* emphasize that a depository bank must be culpable in order for it to be held liable as the recipient of a preferential transfer. Moreover, only by focusing on whether the Bank accepted the deposits in good faith in the regular course of its business can a court prop-

erly apply the "fraud or collusion" requirement contained in *Massey*. By disregarding the Bank's innocence and good faith conduct here, the Second Circuit ignored this Court's reasoning in *Massey*. *See also* MacLachlan, Bankruptcy §292, at 343 (1956) ("True, the cases do not permit the Bank to apply and retain deposits for a special purpose or deposits made pursuant to an agreement between the Bank and the depositor that the account be built up while other creditors are kept waiting, but the mere fact that such a result was achieved is considered insufficient evidence of an agreement to that effect. . . .").

II

The decision below conflicts with the decisions of other courts of appeals.

The Second Circuit's opinion not only ignores the "fraud or collusion" requirement established in *Massey, supra,* but also conflicts with the decisions of other* courts of appeals that have followed *Massey*. The Fourth Circuit's decision in *Citizen's Nat'l Bank* v. *Lineberger,* 45 F.2d 522 (4th Cir. 1930), is most often cited by courts to explain the applicable law.

In *Lineberger,* the plaintiff-trustee in bankruptcy asserted that the defendant bank's set-off after bankruptcy constituted a voidable preference, primarily because the

* Indeed, the Second Circuit overruled, in effect, its own prior decisions upholding an innocent bank's right of set-off. *See, e.g., Matters* v. *Manufacturers Trust Co.,* 54 F.2d 1010, 1013 (2d Cir. 1931) (". . . [I]f there is to be a recovery, the bank must understand that the account is being built up so as to be available at the proper time for seizure.").

bank knew of the depositor's insolvency when deposits were made in the depositor's checking account. Holding that the bank was still entitled to set off the moneys on deposit against the depositor's indebtedness, and relying on this Court's decision in *Massey, supra,* the court found that a "deposit in a bank is not a sale or parting with property, or its possession, as a payment, pledge, mortgage, gift or security." 45 F.2d at 527-28. More significant was the court's finding of no "fraud or collusion" between the depositor and the bank, even though (1) the bankrupt's officers and stockholders had personally guaranteed the bankrupt's obligation to the bank; (2) the bank's president was the brother-in-law of one of the guarantors and was told of the bankrupt's financial condition almost 3 weeks before bankruptcy; and (3) deposits were made in the bankrupt's account during this three-week period. 45 F.2d at 523-24.

> "*There is no evidence whatever of any agreement or understanding between the officers of the bankrupt company and the bank that deposits were to be piled up for the payment or security of the bank. There is no evidence that they were not to be withdrawn at any time that the company saw fit to check against them.* Its checks against them, as a matter of fact, were paid; and there is nothing upon which to base even an inference that a check withdrawing the entire deposit would not have been honored up until the very day of the filing of the petition in bankruptcy. . . .
>
> "It is true that the bank had notice that the company was in financial difficulties and that it was making an offer of compromise to its creditors, but we do not think that this affected the nature of the deposits or precluded the bank from applying the deposit balance against the notes which it held. We have already seen

> that the bank's knowledge of the insolvency of the depositor does not have this effect, and there is no reason in law or in logic why the added element of knowledge of the offer of compromise should do so: *for such knowledge does not show collusion between the bank and the company, nor does it rob the deposit of the distinguishing characteristic of being subject to the control of the depositor and withdrawable at his will.*"
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> "... The deposit of money in the bank in ordinary course of business was no violation of the agreement to preserve and protect the assets in the interests of all creditors, nor, as we have seen, was it a preferential transfer. *If there had been collusion between the officers of the company and the bank, or other circumstance showing that the deposits were not made in ordinary course of business, the bank would have been precluded from asserting a set-off with respect to the deposits ....*
>
> "... Even though a corporation be insolvent, it does not lose the right of doing business in the ordinary way with a bank, *nor does a bank in doing business with it relinquish any of its ordinary rights or remedies.* If there were showing that the deposits in question were made fraudulently or collusively, as a cloak for payments to the bank or as a means of giving it security, the trustee could avoid them under the Bankruptcy Act, without resort to the trust fund doctrine, *if the bank were shown to have been a party to the fraud or collusion, or to have accepted the deposits as a means of obtaining payment or security.*"

45 F.2d at 530-31. [Emphasis added.] The court emphasized that the defendant bank must have some degree of culpability for it to lose its right of set-off; there must be an "agreement or understanding between the officers of the bankrupt company and the bank that deposits were to be piled up for the payment or security of the bank."

45 F.2d at 530. *See* Morris, "Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens", 54 Minn. L. Rev. 730, 738-740 (1970). ("The present test [of avoidability] is not stated in terms of culpability, but it does include culpable creditors—those who are privy to the debtor's plan to supersede the bankruptcy scheme of distribution.").

The Eighth Circuit also requires a showing of "fraud or collusion" in order to preclude a bank from exercising its right of set-off. In *Farmers Bank of Clinton, Missouri v. Julian,* 383 F.2d 314 (8th Cir.), *cert. denied,* 389 U.S. 1021 (1967), the court of appeals reversed the bankruptcy court's finding of a voidable preference when a bank set off the funds on deposit in the bankrupt's general checking account. Although the bankruptcy judge found that substantial deposits were made in the bankrupt's account immediately preceding bankruptcy, the defendant bank was permitted to keep the moneys set off because of the absence of any collusion between the bankrupt and the bank.

> "The Bank did not avail itself of the right of set-off until after an official of the Bank on the morning of June 30 had gone to [the bankrupt's] place of business to discuss [with the bankrupt] and an agent of [a third party] the making of a long-term capital loan. ... It was not until the officer of the Bank found out that [the third party] would not make the long-term loan that the Bank proceeded to set off the account. It was at that point that the officer of the Bank returned to the Bank and made an immediate setoff.
>
> "The Bank on that same day had already honored a number of checks totaling some $1,400. This evidence clearly indicates that there was no collusive build-up of the bank account and that the Bank only

decided to make the setoff on the day the setoff was actually executed. The refusal of [the third party] to proceed with the long-term capital loan triggered the Bank's decision to avail itself of the setoff right.

"... [T]here is absolutely no evidence of any collusive or pre-arranged plan of action between [the bankrupt] and the bank to build up this account."

383 F.2d at 325. Although the Second Circuit purported to distinguish the *Julian* case on the ground that the bank accounts "were long-standing, active accounts" (App. I, at 11), it is submitted that the absence there of collusion between the bankrupt and the bank was controlling. Moreover, the Second Circuit's statement that there "was *no* evidence that the funds were ... deposited by the bankrupt other than in the regular course of [its] business" (App. I, at 10-11) is contradicted by the facts in the *Julian* case.

> "The Referee's reasons were that on June 27, 1959, the bankrupt's bank balance was $34.84; on June 29, 1959 it was $10,581.15 plus an additional deposit on that same day of $762.15; and on June 30, 1959, a deposit of $480 was made. These deposits built up the account to $11,197.14, which build-up the Referee found to be under 'pre-arrangement'."

383 F.2d at 324. Thus, there *was* evidence of an intentional build-up by the depositor prior to bankruptcy in *Julian*. Because there was no evidence "of any collusive or pre-arranged plan of action between" the bankrupt and the defendant bank, however, the bank's set-off was upheld.

Similarly, the First Circuit has emphasized that the defendant bank must be culpable before it can be denied its right of set-off. In *Plymouth County Trust Co.* v.

MacDonald, 60 F.2d 94 (1st Cir. 1932), the indebtedness of the bankrupt was evidenced by demand notes. In June of 1929, a meeting of the bankrupt's shareholders was held, and attended by the president of the defendant bank. At that time, the shareholders voted to allow the bankrupt to continue in business for three more months, and no objection was made by the president of the bank. The bankrupt continued to make deposits with the bank after the shareholders' meeting. According to the court,

> "it does not follow because a bank knows that a depositor is insolvent that the application of funds on deposit in a checking account to a claim against a depositor constitutes a preference. A bank is permitted to apply funds on deposit, *and received in the usual course of business,* to a claim against the depositor under section 68 of the act (11 U.S.C.A. §108) relating to set-offs." [Citations including this Court's decision in *Massey, supra,* omitted.]
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> "The deposits prior to July 10 were, of course, not made by the bankrupt with any idea of giving a preference to the bank, *nor were they received,* as the referee found, *with any intent on the part of the bank to apply them to its claim,* but subject generally to the corporation checks. The bank continued to receive deposits and honor checks up to July 12th. It was not until the receipt of the check for $15,100.78 on the morning of the 12th that the officers of the bank evidently saw an opportunity to anticipate a loss they foresaw it would inevitably suffer, and applied all collected funds to the note. Even though the bank officials well knew that their proposed action would force an assignment or bankruptcy, the bank had its right to set-off, even prior to bankruptcy, *of any sums received on deposit in the usual course of business.* That a creditor

> with a right of set-off thereby secures an advantage to the extent of its claim against the bankrupt is not the test. Was it done, knowing that the debtor was insolvent and with the intent to secure a preference within the meaning of the Bankruptcy Act?
>
> "The deposits making up the $4,027.29 applied on July 12th [which had been deposited on July 10], were made with the understanding on the part of the depositor that they were subject to be withdrawn on its checks for a period of at least three months, and *were received by the bank with the same understanding.* The record discloses *no intent on the part of the bank* on receiving deposits prior to July 10th to apply them on its note, but rather an *intent to hold them subject to check,* and they were, of course, deposited by the bankrupt, to be drawn against as needed in conducting its business."

60 F.2d at 96-97. [emphasis added.] Thus, the First Circuit also required some evidence of "fraud or collusion" between the bankrupt and the defendant bank in order to find a "transfer" so as to deprive the bank of its right of set-off. The Second Circuit, however, would hold the Bank liable here, regardless of its intent or its innocence. App. I, at 12. Because there is now a conflict in the circuits as to the proper construction of an important and often-used* term in the Act—"transfer"—this Court should grant a writ of certiorari in order to resolve this issue of importance in bankruptcy litigation.

* Virtually all of the avoiding powers of a trustee in bankruptcy are based on the definition of "transfer". *See, e.g.,* Sections 60a, 67d, 70c and 70e of the Act; 3 Collier, Bankruptcy ¶60.01, at 743-55 (14th rev. ed. 1975).

III

Congress has consistently refused to limit a bank's right of set-off in the manner prescribed by the court below.

The dissent in the Second Circuit noted that "Congress has refused to eliminate" a bank's right of set-off in the case of a financially distressed debtor. App. I, at 17. By eliminating, in effect, an innocent bank's right of set-off here, the majority in the Second Circuit has substituted a new and debatable rule which has been rejected by Congress.

In 1936, the National Bankruptcy Conference included in the original draft of the Chandler amendment to the Bankruptcy Act a new provision declaring deposits in a creditor bank to be transfers and subjecting them to the same tests of a voidable preference as other transfers under Section 60 of the Act. The history of this proposed legislation has been succinctly described as follows:

> "[The proposed legislation] was designed to meet the case where instead of making a transfer of property to a creditor, the debtor loaned him money. It was probably broad enough to include the set-off of deposits by banks which [the proposed legislation] specifically covered. Professor McLaughlin of Harvard University was largely responsible for [the proposed legislation] and had ardently championed the theory underlying it. He did not propose to abolish the banks' right of set-off, but he felt that after the bank had learned that a depositor to whom it had loaned money was insolvent, it should not be able to profit from the fact that additional deposits were made by the depositor. Banks

and banking associations, on the other hand, felt that there was a difference between the extension of bank credit and the extension of ordinary commercial credit, and that unless a bank was able with some degree of safety to carry a depositor after it had learned of his financial difficulties, many customer depositors would be driven into bankruptcy who might otherwise extricate themselves from their financial difficulties.''

* * *

''Nevertheless, Professor McLaughlin did not prevail, and in subsequent forms of the Chandler Act, H.R. 6439 (April 15, 1937) and H.R. 8046 (July 28, 1937, subsequently enacted) [the proposed legislation was] omitted from the provisions of §68. The legislators evidently thought along the same lines as Mr. Justice Lamar in *Studley* v. *Boylston National Bank,* [229 U.S. 523, 529 (1913)] when he stated that an effort to enlarge the scope of the statute to deny the banks' right of set-off 'would in many cases make banks hesitate to honor checks given to third persons, would precipitate bankruptcy and so interfere with the course of business as to produce evils of serious and far-reaching consequence'.''

4 Collier, Bankruptcy ¶68.01[3], at 845-48 (14th rev. ed. 1975); *see also* 2 Glenn, Fraudulent Conveyances and Preferences §407 (rev. ed. 1940); MacLachlan, Bankruptcy §292, at 343 (1956) (''It is not surprising that banker opposition caused the amendment to be stricken from the Chandler Act. Indeed, a plausible case can be made out for granting banks a straight statutory priority in bankruptcy. Certainly a failing depositor can procure a longer extension of bank credit if the bank is going to be in a favorable position as against other creditors, and sometimes the extension saves a situation and prevents a failure.'').

Current proposals to revise the Bankruptcy Act still preserve a bank's right of set-off for valid reasons. According to the House Committee Report accompanying one of the most recently proposed revisions of the Bankruptcy Act,

''[s]etoff most often arises in the bank context. Although the governing principles may be same for the bank context as for mutual debts and credits among merchants, the fact patterns are most often different. Banks are generally more familiar with the financial affairs of their debtors than are arms-length merchants. Especially when a debtor is sinking into financial difficulty, the bank will take an increased interest in the operations of the debtor. In order to encourage a bank to carry a debtor through difficult times without the threat of losing a setoff right after bankruptcy, it may be desirable to permit . . . bank setoff in any event.''

* * *

''Different treatment of setoff that occurs prepetition and postpetition may generate problems for insolvent debtor. If the restrictions placed on postpetition setoff are greater than those placed in prepetition setoff, there is an incentive for creditors with a right of setoff, especially banks, to offset during a period of financial difficulty of the debtor, rather than continuing to carry the debtor in hopes that matters will improve. . . .''

* * *

''. . . The result [of the proposed legislation] is to encourage business workouts, by discouraging precipitious [sic] action.''

H.R. Rep. No. 595, 95th Cong., 1st Sess. 184-86 (1977); H.R. 8200, 95th Cong., 1st Sess. §101 (proposed 11 U.S.C. §553) (1977); S. 2266, 95th Cong., 1st Sess. §101 (proposed 11 U.S.C. §553) (1977). Because courts are supposed to con-

strue what Congress has said, and not substitute their own views of what the law should be, this Court should grant the writ of certiorari to review the Second Circuit's decision.

IV

The decision below conflicted with the applicable standards for summary judgment articulated by this Court and other circuits.

The Second Circuit held that the "trustee's allegations," in and of themselves, "raised a sufficient question of fact to make summary judgment inappropriate . . .," App. I, at 7, n.6. This holding contradicts not only the plain language of Fed.R.Civ. P. 56(e), but also the established standard of this Court and other circuits.

Fed.R.Civ.P. 56(e) provides in pertinent part that a party responding to a motion for summary judgment "*must set forth specific facts* showing there is a genuine *issue for trial.*" [emphasis added.] He cannot merely rest on the "allegations . . . of his pleading." In effect, the Second Circuit has read this rule out of plenary suits brought by a trustee in bankruptcy.

A. This Court's Criteria for Opposing a Motion for Summary Judgment

In *First National Bank* v. *Cities Service Co.*, 391 U.S. 253 (1968), this Court held "that a party cannot rest [merely] on allegations . . . in opposition to a properly supported summary judgment motion made against him." 391 U.S. at 290. There, the plaintiff charged that the de-

fendant was part of an international oil cartel which had effectively boycotted plaintiff's oil. This Court affirmed the lower court's decision granting defendant's motion for summary judgment. According to the Court, the pleadings showed no motive on the defendant's part to engage in an illegal conspiracy, nor did the plaintiff come forward with evidence to rebut the defendant's documented explanation that the unattractiveness of plaintiff's offer deterred defendant's purchase.

> "To the extent that petitioner's burden-of-proof argument can be interpreted to suggest that Rule 56(e) should, in effect be read out of antitrust cases and permit plaintiffs to get to a jury on the basis of the allegations in their complaints, coupled with the hope that something can be developed at trial in the way of evidence to support those allegations, we decline to accept it. While we recognize the importance of preserving litigants' rights to a trial we are not prepared to extend those rights to the point of requiring that anyone who files an antitrust complaint setting forth a valid cause of action be entitled to a full-dress trial notwithstanding the absence of any significant probative evidence tending to support the complaint."

391 U.S. at 290.

The Court's reasoning is applicable here. The Second Circuit's holding that "summary judgment [is] inappropriate," App. I at 7, n.6, was based solely on

> "[t]he trustee's *allegations* about [the Bank's president's] continuous knowledge of the course of Oakland's accelerating financial difficulties and his communications with Brede. . . ." [emphasis added.]

App. I, at 7, n.6. According to the court below,

> "[*i*]*f* [*the Trustee's*] *allegations* [*were*] *proven,* [it] would satisfy the requirement of the district court's legal test that there be dealings outside the regular

> course of the bank's business or complicity between Brede and the bank. *These allegations raised a sufficient question of fact to make summary judgment inappropriate. . . .*"

App. I, 7, at, n.6. [Emphasis added.] Although the Second Circuit focused on the Trustee's allegations, it significantly failed, as did the Trustee, to show any evidentiary support for such allegations. Thus, to support his allegation of the Bank's "continuous knowledge of . . . Oakland's accelerating financial difficulties and [its] communications with Brede," the Trustee relied exclusively on "informal discussions" with third persons described in his own self-serving answers to the Bank's interrogatories and his own deposition taken by the Bank. *See* Joint Appendix filed in Second Circuit ("Joint App."), at 15-16.

Although Fed. R. Civ. P. 56(e) requires "opposing affidavits [to] be made on personal knowledge, [and] set forth . . . facts . . . admissible in evidence," the Trustee submitted no such evidence in opposition to the Bank's motion, and the Second Circuit cited none. Thus, the Second Circuit has read Rule 56(e) out of bankruptcy cases so as to permit the Trustee to get to a jury on the basis of his unsupported allegations. Significantly, the Trustee offered no affidavit or deposition testimony from either of the persons on whom his hearsay evidence is based. His examination of Brede in the bankruptcy court, however, on October 12, 1971 (Joint App., at 190), contradicts the unsupported allegations on which the Second Circuit relied. Thus, unless the Court is now willing to make an exception to Rule 56(e) for trustees in bankruptcy, a trustee can obtain a jury trial in the Second Circuit, despite the absence of any evidence to support the allegations of his complaint.

B. The Decisions of Other Circuits

The Second Circuit's holding that a party's allegations are alone sufficient to overcome a motion for summary judgment would emasculate Fed.R.Civ.P. 56(e). For that reason, other circuits have required trustees in bankruptcy to support their allegations with evidence in order to withstand a motion for summary judgment.

In *King* v. *National Industries, Inc.*, 512 F.2d 29 (6th Cir. 1975), which had a fact pattern similar to that presented here, the Sixth Circuit expressly refused to let a trustee oppose a motion for summary judgment by merely resting on his allegations, the truth of which would assertedly be established at trial. There, the trustee of a Chapter X debtor commenced an action to set aside a transaction on the grounds that it was a fraudulent conveyance under Sections 67d and 70e of the Act. The court focused on whether there had been a "transfer" of the debetor's "property" within the meaning of Section 1(30) of the Act, without which, the court held, there could be no fraudulent conveyance. 512 F.2d at 32. The defendant moved for summary judgment, relying on an affidavit which showed that the debtor never had a beneficial interest in the subject property. In response, the plaintiff-trustee submitted his attorney's affidavit which "stated that while plaintiff was unable at that time to offer countervailing affidavits from persons having personal knowledge of the circumstances . . . , he could point to evidence which would be available to him at trial to support his position." 512 F.2d at 31.* In

* The affidavit submitted here by the Trustee's attorney, the only affidavit submitted by the Trustee, does not even go this far. *See* Joint App., at 31-33.

affirming the district court's decision granting the defendant's motion for summary judgment, the Sixth Circuit explained as follows:

> "Summary judgment in this case for [the defendant] was proper since no genuine issue of material fact was raised by plaintiff. The issue upon which the case turns is whether plaintiff had 'property' which could be transferred under the 1970 agreement in violation of the Bankruptcy Act. The issue has been extensively briefed and was an appropriate one for decision by the district judge as a matter of law. The affidavit of plaintiff's attorney Palmer was insufficient to rebut the affidavit of Solomon accompanying defendant's motion for summary judgment. *Plaintiff may not raise an issue of fact by merely referring to the proposed testimony of possible witnesses.* Palmer [plaintiff's attorney] in his affidavit indicates no personal knowledge of the facts relevant to the case. *An affidavit stating what the attorney believes or intends to prove at trial is insufficient to comply with the burden placed on a party opposing a motion for summary judgment under Rule 56. Automatic Radio Mfg. Co.* v. *Hazeltine Research Inc.*, 339 U.S. 827, 831, 70 S.Ct. 894, 94 L. Ed. 1312 (1950), *Mercantile National Bank at Dallas* v. *Franklin Life Insurance Co.*, 248 F.2d 57, 59 (5th Cir. 1957)."

512 F.2d at 34. [Emphasis added.] The Sixth Circuit's reasoning is equally applicable here, and underscores the conflict between the Second and Sixth Circuits. Here, the Trustee's attorney submitted only his affidavit in opposition to the Bank's motion for summary judgment, without more. That affidavit has virtually no probative value. *Mercantile Nat'l Bank at Dallas* v. *Franklin Life Ins. Co.*, 248 F.2d 57, 59 (7th Cir. 1957) ("Based upon these facts, the court below granted the beneficiary's motion for summary judgment. . . . There were no affidavits on file, except that the attorneys for the rival claimants appended their own affidavits to some of the pleadings. In no instance did such affidavits show that the facts were based upon the affiants' knowledge; or that they otherwise complied witht the requirements of Rule 56(e) F.R. Civ. P., 28 U.S.C.A. In fact it is obvious that the attorneys did not have any personal knowledge of the facts and that they were not competent to testify to them. Such affidavits have no probative value on a motion for summary judgment. 6 Moore's Federal Practice, 2d Ed., pp. 2325 and 2330."); *Minnesota Mining & Mfg. Co* .v. *United States Rubber Co.*, 279 F.2d 409, 416 (4th Cir. 1960) (". . . the affidavit of counsel based upon hearsay and not upon personal knowledge does not satisfy the requirement of [Fed. R. Civ. P. 56(e)], Chapman v. U.S., 8th Cir., 139 F.2d 327."); *Antonio* v. *Barnes*, 464 F. 2d 584, 585 (4th Cir. 1972) ("Our examination of the affidavits persuades us that the challenge of their sufficiency is valid. While each affidavit states that the affiant is 'competent to make this affidavit,' there is no showing whatever that the statements therein were made on personal knowledge as required by the Rule [56]. From the face of the affidavits, they might well be based on mere hearsay or, at best, reflect only a summary of the general routine prescribed for the institution. The absence of an affirmative showing of personal knowledge of specific facts vitiates the sufficiency of the affidavits. . . ."). Moreover, there is nothing in the record here which even tends to show fraud or collusion between Oakland and the Bank, or that the Bank accepted Oakland's deposits other than in the ordinary course of its business. To the contrary, two persons with personal knowledge of the facts have contradicted the Trustee's bare assertions. Joint App., at 136-37, 190.

The Fifth Circuit also requires probative evidence to withstand a motion for summary judgment. In *Solomon v. Houston Corrugated Box Co., Inc.*, 526 F.2d 389 (5th Cir. 1976), the Fifth Circuit explained the circumstances under which a "genuine" issue of fact remained for trial. There, the plaintiff commenced an antitrust action alleging that the defendant, his major supplier, had agreed to sell its product solely to plaintiff's chief competitor, the co-defendant, in order to insure that the competitor would monopolize the trade. The defendants moved for summary judgment, introducing sworn, reasonable and believable evidence concerning business dealings rebutting plaintiff's allegations. In affirming the granting of the defendants' motion, the Fifth Circuit reasoned as follows:

> "The mere allegation of the Sherman Act claim requirements of a contract, combination, or conspiracy for the purpose of restraining trade or interstate commerce and resulting damages are not sufficient to withstand a motion for summary judgment once they have been rebutted, *ALW, Inc.* v. *United Air Lines, Inc.*, 510 F.2d 52, 54-57 (9th Cir. 1975); see, e.g., *Kemp Pontiac-Cadillac, Inc.* v. *Hartford Automobile Dealers' Ass'n*, 380 F.Supp. 1382, 1389 (D.Conn. 1974) ('glib and conclusory allegations' of conspiracy are insufficient to raise genuine issues in face of specific denials in sworn depositions and affidavits by defendants); *Searer* v. *West Michigan Telecasters, Inc.*, 381 F.Supp. 634, 643 (W.D.Mich. 1974) (the policy of sparing use of summary procedures in antitrust cases 'is no warrant for every plaintiff who can draft an antitrust complaint, no matter how groundless or improbable its allegations, to force his claim to trial despite its deficient factual underpinnings'); *Murdock* v. *City of Jacksonville*, 361 F.Supp. 1083, 1086-87 (M.D.Fla. 1973) ('Even in an antitrust case a party cannot rest on the allegations contained in his complaint but must, in opposition to a motion for summary judgment, come forward with affidavits setting forth specific facts showing that there is a genuine issue of material fact for trial') (citations omitted).
>
> "We have recently had occasion to apply these principles in *Scranton Construction Co.* v. *Litton Industries Leasing Corp.*, 494 F.2d 778, 782 (5th Cir. 1974), *cert. denied*, 419 U.S. 1079, 95 S.Ct. 774, 42 L. Ed.2d 800 (1975), wherein we stated:
>
>> 'We have searched the record in vain for evidence supporting plaintiffs' allegations of a combination or conspiracy against them between Litton and anyone in the area of plaintiffs' claims. Proof of this is, of course, essential to plaintiffs' case under §1 of the Sherman Act and to its conspiracy claims under §2. Facing defendants' sworn challenge to the existence of such a conspiracy, it was up to plaintiffs to produce *significant probative evidence*—by affidavit or deposition—demonstrating that a *genuine* issue of fact existed as to this element of the complaint, if summary judgment was to be avoided. (citations omitted, emphasis added).'
>
> "Similarly, a review of the record in this case reveals a total lack of any significant probative evidence, by means of sworn affidavits or depositions, supportive of appellant's contention that genuine issues of material fact exist."

526 F.2d at 393-394 [emphasis in text].

In *Golden Oil Co., Inc.* v. *Exxon Co., U.S.A.*, 543 F.2d 548 (5th Cir. 1976), the Fifth Circuit reiterated its requirements for opposing summary judgment:

> "It is elementary that when the party moving for summary judgment supports his motion with sworn matter or admissions, the opponent bears a burden of present-

ing affidavits or other proper matter sufficient to create a genuine dispute of fact. Pleadings will not suffice to defer the evil day, and the opposing party, facing such a situation, may not choose to wait until trial to develop claims or defenses relevant to the summary judgment motion."

543 F.2d at 548.

In this case, the Trustee could not produce more than vague, conclusory and unsupported allegations in opposition to the Bank's motion for summary judgment. The district court correctly found that he would have no more convincing evidence at trial. Indeed, the Trustee "conceded that if on the law relief required the bank's involvement in the build-up of the account, and if there was nothing in the papers before the court to create a question of fact as to the bank's participation, collusion or complicity in a plan by Brede to prefer the bank over the other creditors, then summary judgment would have to be granted to the defendant." App. II, at 25.

This case had been pending in the district court for more than three years before the hearing on the Bank's motion for summary judgment. During that time, the Trustee deposed Mr. Famighetti, the only officer of the Bank with personal knowledge of the facts. In addition, the Trustee examined a multitude of documents, and had more than three years to obtain whatever proof might be necessary to oppose the Bank's motion. He had ample opportunity, of which he availed himself, to examine the Bank's files and records to search for any documents relating to his assertions. Nevertheless, the Trustee submitted no evidence which would preclude the district court from grant-

ing the Bank's motion for summary judgment. As even the Second Circuit recognized prior to its decision here, a party opposing a motion for summary judgment, like the Trustee, must produce "significant probative evidence tending to support [his position]." *United States* v. *Pent-R-Books, Inc.*, 538 F.2d 519, 529 (2d Cir. 1976), *cert. denied,* 45 U.S. L.W. 3586 (March 1, 1977). If summary judgment is to remain vital in the Second Circuit, the Court must grant the writ of certiorari here to insure a uniform construction of the Federal Rules of Civil Procedure. *Northwestern Nat'l Ins. Co.* v. *Corley*, 503 F.2d 224, 230 (7th Cir. 1974) ("... [R]esort to summary judgment is a 'salutary procedural device,' . . . utilization of which in all appropriate cases should be encouraged rather than discouraged. . . ."); *Bland* v. *Norfolk & Southern R. R.*, 406 F.2d 863, 866 (4th Cir. 1969) ("While a day in court may be a constitutional necessity when there are disputed questions of fact, the function of a motion for summary judgment is to smoke out if there is any case, i.e., any genuine dispute as to any material fact, and, if there is no case, to conserve judicial time and energy by avoiding an unnecessary trial and by providing a speedy and efficient summary disposition.").

The Trustee failed to produce any evidence in the district court or in the Second Circuit to show that Oakland's deposits had not been received by the Bank in the ordinary course of its business, that such deposits had not been subject to withdrawal by Oakland, or that there was anything else unusual about such deposits. Nor was there any evidence to show that the Bank was in collusion with Oakland to build up the Glen Head Account so as to give the Bank preferred treatment over other creditors. Indeed,

the uncontradicted evidence shows that the Bank knew nothing of the bankrupt's plight until *after* the deposits in question were made, and only one day before the set-off. Accordingly, the district court properly granted the Bank's motion for summary judgment, in reliance on the criteria uniformly established by other circuits for determining motions for summary judgment.

Trustees in bankruptcy should be treated like other litigants, and should not be able to obtain a jury trial in the federal courts without probative evidence to support the allegations of their complaints. Because the Second Circuit has, in effect, given special status to these litigants in actions outside of the bankruptcy court, in contrast to the decisions of other circuits, this Court should review the decision below.

Conclusion

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

MICHAEL L. COOK
Attorney for Petitioner
767 Fifth Avenue
New York, New York 10022
(212) 758-7800

LAWRENCE MITTMAN,
WEIL, GOTSHAL & MANGES,
Of Counsel.

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Appendices

Decision of the Second Circuit

TIMBERS, *Circuit Judge:*

Donald Katz, trustee in bankruptcy of the Oakland Foundry Company of Belleville, Illinois, Inc. (Oakland), sued The First National Bank of Glen Head (the Bank) in the Eastern District of New York to recover $108,732.07 which the trustee alleged constituted a voidable preference under §60 of the Bankruptcy Act, 11 U.S.C. §96 (1970).[1] The district court, George C. Pratt, *District Judge,* in an opinion filed October 19, 1976 granted the bank's motion for summary judgment and dismissed the trustee's complaint. From the judgment entered accordingly on October 22, 1976, the trustee has appealed.

1. Throughout this opinion all statutory citations, unless otherwise stated, are to sections of the Bankruptcy Act, Title 11 of the United States Code, 1970 revision.

For example, here §60(a)(1), 11 U.S.C. §96(a)(1), provides:

> "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

The term "transfer" is defined in relevant part in §1(30), 11 U.S.C. §1(30), as follows:

> " 'Transfer' shall include the sale and every other and different mode, direct or indirect, of disposing of or parting with property or with an interest therein or with the possession thereof . . . , absolutely or conditionally, voluntarily or involuntarily, . . . as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security or otherwise."

§60(b), 11 U.S.C. §96(b), authorizes a trustee in bankruptcy to avoid a preference "if the creditor receiving it or to be benefited thereby . . . has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

The district court, in granting the bank's motion for summary judgment, assumed for purposes of the motion that the depositor was in fact insolvent at the time of the deposits and later set-offs, and that the bank had reasonable cause to believe it to be insolvent. Thus the narrow holding of the court below was that, since the bank had obtained the funds of the bankrupt by setting off money on deposit with the bank in the bankrupt's checking account, in conformity with §68(a), 11 U.S.C. §108(a),[2] there was no "transfer", and absent a transfer, no preference that could be avoided by the trustee.

We reverse and remand for trial in order to resolve certain issues of fact which we shall discuss more fully below. In reversing and remanding we are mindful of the traditional rule that in order to prove a voidable preference the trustee must show complicity or understanding on the part of the bank. This is in accordance with a long line of authority that a bank is entitled to set off deposits which were accepted in good faith and in the regular course of the bank's business. This rule in turn is premised on practical commercial considerations; it has survived the test of time; and, absent compelling reasons for doing so, it should not be disturbed. Within this framework, we hold that the district court misinterpreted the law and erroneously applied its

2. §68(a), 11 U.S.C. §108(a), provides:

"In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

The Supreme Court has approved a bank's right of set-off in *Studley* v. *Boylston National Bank,* 229 U.S. 523 (1913), and in *New York County Bank* v. *Massey,* 192 U.S. 138 (1904).

interpretation to the allegations of the complaint, thus foreclosing a jury's resolution of such critical issues of fact as whether, in view of the build-up and real nature of the Glen Head account, the bank acted in good faith in accepting the deposits or whether the account in fact was a general deposit account. To resolve these and other issues of fact we reverse and remand.

I.

The course of events which lead to the bank's exercise of its asserted right of set-off began on January 16, 1969 when the bank made a $125,000 loan to Oakland. This loan was obtained for Oakland by its president and chief executive officer, Herman Brede. Oakland was a wholly-owned subsidiary of Electronic Cabinets, Inc., all of whose stock was owned by Brede and his wife. Oakland's indebtedness to the bank was guaranteed personally by the Bredes, as required by the bank, and was secured by a pledge of all of the Bredes' stock in Electronic Cabinets, Inc. and all of their stock in another company wholly owned by the Bredes. When Oakland's indebtedness to the bank later was converted to a demand note in June 1970, the Bredes gave the bank additional security in the form of a second mortgage on their home. Pursuant to the bank's usual practice, Oakland opened a general checking account with the bank when the loan was first made.

Oakland had been having financial difficulties even before it obtained the loan from the bank. Its financial condition deteriorated until it virtually ceased doing business in March 1971. By June 1971 Oakland had either ceased making or reduced significantly office and factory payroll.

In the district court proceedings the trustee sought to show that Oakland's deposits in its Glen Head account constituted preferences by comparing the activity in that checking account with the activity in Oakland's checking accounts in an Illinois bank. The trustee also sought to prove that practically all of Oakland's banking activity was carried on through two accounts in the Illinois bank, while the Glen Head account remained substantially inactive from July 1970 until March 1971. During this period Oakland made only a few deposits in and withdrawals from the Glen Head account and the balance never rose above $5,800. Beginning April 20, 1971 this pattern changed markedly. From April 20 to June 30 Oakland built up the balance in its Glen Head account from $865.09 to over $100,000. During this period no withdrawals were made. The first reduction in the balance occurred on June 30 when the bank set off the sum of $108,783.91 against the $125,000 which Oakland owed on the loan.

The trustee also sought to prove that Anthony D. Famighetti, the bank's president and the officer primarily concerned with the Oakland loan, was aware of Oakland's worsening financial condition and that he was aware that the Glen Head account was being built up in anticipation of Oakland's impending bankruptcy, thus to be available for a set-off by the bank. On June 29, 1971 Brede called Famighetti to apprise him of Oakland's difficulties. Brede told Famighetti that he would try to work something out with Oakland's creditors. Famighetti immediately placed a freeze on Oakland's account. On June 30 the bank executed the set-off and applied it against the outstanding $125,000 loan. On July 15 an involuntary petition in bankruptcy was filed in the Eastern District of Illinois against Oakland which was adjudicated a bankrupt on August 18.

For purposes of the bank's motion for summary judgment the district court correctly accepted as undisputed the essential facts summarized above to the extent that they were asserted by the bank in support of its motion and admitted by the trustee in his answering papers. On the basis of the undisputed facts the court concluded that Oakland's Glen Head deposits were not made in the regular course of Oakland's business. The court nevertheless dismissed the complaint on the ground that "[t]he test [for determining whether a 'deposit' really is a 'transfer'] is not whether the deposits were made in the depositor's regular course of business, but instead, whether they were accepted by the bank in its regular course of business."

We hold that the legal standard articulated by the district court was erroneous. We further hold that, whether under the standard articulated by the district court or under the correct standard, the bank's motion for summary judgment should have been denied because there remained triable issues of fact, including whether the bank was aware of Oakland's intentional build-up of its account as reflected in the bank's acceptance of the deposits other than in the bank's regular course of business.

II.

Section 60(a) defines a preference in terms of six key elements.[3] Only one is of concern here. The district court

3. The statute, note 1 *supra*, states that a preference exists only if all six statutory elements are present:

"(1) There must be a transfer of the debtor's property, (2) to or for the benefit of a creditor, (3) for or on account of an ante-

(footnote continued on next page)

assumed that elements (2)-(6) of §60(a) were present. We likewise assume that the trustee, if afforded the opportunity at trial, could prove elements (2)-(6) in Oakland's series of deposits in its Glen Head account. The only remaining issue is the requirement of element (1) that there be a "transfer"[4] of the debtor's property.[5]

The district court concluded that there had been no transfer because Oakland deposited its funds in an ordinary checking account from which it could make withdrawals, until the bank imposed the freeze on June 29, 1971. In view of this factor, and because the court concluded that the trustee could not prove any agreement or complicity between Oakland (Brede) and the bank with regard to building up the account, the court concluded that

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cedent debt; (4) the transfer must be made or suffered while the debtor is insolvent, (5) within four months of bankruptcy; and (6) the effect of the transfer must be to enable the creditor to obtain a greater percentage of his debt than another creditor of the same class." *Mayo* v. *Pioneer Bank & Trust Co.*, 270 F.2d 823, 834-35 (5 Cir. 1959); 3 Collier on Bankruptcy §60.02, at 758-59 (Moore ed. 1976).

4. The statute, note 1 *supra*, defines "transfer" broadly. It is meant to preclude ingenious methods of circumvention:

> "All technicality and narrowness of meaning is precluded. The word is used in its most comprehensive sense, and is intended to include every means and manner by which property can pass from the ownership and possession of another, and by which the result forbidden by the statute may be accomplished. . . ." *Pirie* v. *Chicago Title & Trust Co.*, 182 U.S. 438, 444 (1901).

Accord, *National Bank of Newport* v. *Herkimer Bank*, 225 U.S. 178, 184 (1912).

5. The district court focused on the set-off itself and inquired whether *it* constituted a transfer. The district court did not explicitly consider whether the *deposits* amounted to transfers within the meaning of the Bankruptcy Act. We shall include in our analysis whether the deposits were transfers, as have most of the courts in similar cases.

the relationship between Oakland and the bank did not differ from an ordinary debtor-creditor relationship. This was the predicate for its conclusion that Oakland's deposits were not transfers within the meaning of §60.[6]

It is well settled that deposits in an unrestricted checking account, made in the regular course of business, do not constitute transfers within the meaning of the Bankruptcy Act. *New York County Bank* v. *Massey*, 192 U.S. 138, 145 (1904); *Jensen* v. *State Bank of Allison*, 518 F.2d 1, 4 (8 Cir. 1975); *Farmers Bank* v. *Julian*, 383 F.2d 314, 324 (8 Cir.), *cert. denied*, 389 U.S. 1021 (1967); *Joseph F. Hughes & Co.* v. *Machen*, 164 F.2d 983 (4 Cir. 1947), *cert. denied*, 333 U.S. 881 (1948); *Cusick* v. *Second National Bank*, 115 F.2d 150, 151-52 (D.C. Cir. 1940); *Frankford Trust Co.* v. *Comber*, 68 F.2d 471, 472 (3 Cir. 1933); *Citizens' National Bank of Gastonia* v. *Lineberger*, 45 F.2d 522, 526-27 (4 Cir. 1930). The theory of these cases is that a deposit creates a debt owed to the depositor by the bank and does not constitute a parting with property by the depositor. As the court said in *Lineberger*, *supra*, 45 F.2d at 527:

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6. We agree with the trustee's subordinate contention on appeal, as an alternative to its main contention that the court applied an erroneous legal test, that the bank should not have been granted summary judgment even under the test articulated by the court. The trustee's allegations about Famighetti's continuous knowledge of the course of Oakland's accelerating financial difficulties and his communications with Brede, if proven, would satisfy the requirement of the district court's legal test that there be dealings outside the regular course of the bank's business or complicity between Brede and the bank. These allegations raised a sufficient question of fact to make summary judgment inappropriate even under the district court's test.

> "A deposit in a bank . . . does not deplete the estate of the depositor, but results in substituting for currency, bank notes, checks, drafts, and other bankable items a corresponding credit with the bank, which may be checked against . . . . A deposit of funds differs from a payment in the essential particular that it is withdrawable at the will of the depositor."

All of the courts that have relied on a debtor-creditor relationship between bank and depositor to preclude a finding of a transfer have emphasized not only the requirement that the funds be withdrawable at the will of the depositor but also the requirement that the deposits be made in the regular course of business. See, eg., *Maye* v. *Pioneer Bank & Trust Co., supra*, 270 F.2d at 836. Various irregularities might defeat the presumption that deposits ordinarily do not have the effect of diminishing the bankrupt's estate and therefore are not transfers. Certainly when withdrawals are not permitted the deposits constitute payment, for they cannot be said to be in the regular course of business or to establish a mere debtor-creditor relationship between the bank and the depositor. E.g., *Mechanics' and Metals National Bank* v. *Ernst*, 231 U.S. 60, 67 (1913). But the fact that withdrawals *are permitted* does not make mandatory the opposite conclusion that the deposits *cannot* be considered transfers. See *Merrimack National Bank* v. *Bailey*, 289 F. 468, 470 (1 Cir.), *cert. denied*, 263 U.S. 704 (1923).[7]

7. In *Merrimack, supra*, 289 F.2d at 470, the First Circuit rejected the bank's arguments which were similar to those of the bank in the instant case:

"On analysis, the [bank's] claim falls little short of contending that a creditor-depositor bank cannot become a preferred

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In deciding whether a bank's set-off is a "transfer", a court must determine from all the circumstances whether the deposits were made in the regular course of business. In view of the purpose of the inquiry, it does not make sense to consider only the bank's course of business. If the deposits somehow are out of the regular course of the depositor's business, the bank's normal procedures, or the usual course of dealings between the depositor and the bank, then an inference can be drawn that the deposits were not ordinary deposits but served to transfer the depositor's property to the bank. By limiting its inquiry to the regular course of the bank's business, the district court below failed to take into account that "a deposit may be made the cloak for some other transaction, such as payment or the giving of security; and in such case equity, which looks through form to substance, will treat the transaction according to its real nature." *Citizens' National Bank of Gastonia* v. *Lineberger, supra*, 45 F.2d at 527-28.

The bank insists here that a deposit will constitute a transfer under §60(a)(1), only if the trustee can prove the bank's complicity in, agreement to, or conscious awareness

creditor, because it may honor checks on the deposits . . . . We cannot accept this proposition. The fact that such bank creditors may honor checks on such deposits does not control. In this case, checks to cover these deposits were not drawn and paid . . . .

Bank creditors are subject to exactly the same rule of law as to preferences and set-off as are merchandise and other creditors. The different relations arising out of the fact that a bank creditor is also commonly a depositor debtor may require a somewhat different assessment and application of the evidential facts. But in all such cases of preference by set-off the fundamental question is one of fact . . . ."

of, the build-up in the account in anticipation of a set-off. That is not the law. If it were, equity would be precluded from looking through form to substance—even in a case of as blatant a preferential transfer as that alleged by the trustee here.

In many cases a bank has been held to be privy to the building up of a depositor-debtor's account and therefore not to have accepted or received the deposits in the regular course of business. E.g., *Mayo* v. *Pioneer Bank & Trust Co., supra,* 270 F.2d at 834; *Bank of Commerce* v. *Hatcher,* 50 F.2d 719 (4 Cir. 1931); *Blue* v. *Herkimer National Bank,* 30 F.2d 256 (2 Cir. 1929), *cert. denied,* 281 U.S. 750 (1930); *Elliotte* v. *American Savings Bank & Trust Co.,* 18 F.2d 460, 462 (6 Cir. 1927); *Bank of California* v. *Brainard,* 3 F.2d 3, 4 (9 Cir. 1925); *In re Almond-Jones Co.,* 13 F.2d 152, 156 (D. Md. 1926), *aff'd sub nom. Union Trust Co.* v. *Peck,* 16 F.2d 986 (4 Cir.), *cert. denied,* 273 U.S. 767 (1927); cf. *Goldstein* v. *Franklin Square National Bank,* 107 F.2d 393 (2 Cir. 1939) (case remanded for factfinding as to the bank's intent in accepting deposits and its knowledge of the depositor's insolvency), *on remand,* 31 F.Supp. 66 (E.D. N.Y. 1940) (findings of no intent to set off deposits against debt *and* no reasonable cause to believe depositor was insolvent). A bank's participation in the build-up, however, is not a prerequisite to a finding that there has been a transfer. The question has been posed as whether the account of the bankrupt was built up "with the understanding of the Bank". *Farmers Bank of Clinton* v. *Julian,* 383 F.2d 314, 324 (8 Cir.), *cert. denied,* 389 U.S. 1021 (1967); see *Jensen* v. *State Bank of Allison,* 518 F.2d 1, 4 (8 Cir. 1975). The query in each of those cases amounted to dictum because there was *no* evidence that the funds were accepted

by the bank *or* deposited by the bankrupt other than in the regular course of business of either. In both *Julian* and *Jensen,* upon which the district court relied, the bank accounts were long-standing, active accounts; in each case the Eighth Circuit emphasized that there was no intent on the part of the depositor *or* the bank, let alone an agreement between them, to use the deposits as a cloak for payment of a debt. We find those cases to be distinguishable from and therefore not controlling on the issue presented by the instant case.

Here the trustee alleged facts from which it could be inferred that the bankrupt did not make the deposits in its Glen Head account in good faith; that the deposits were not made in the regular course of its business, which already had practically ceased functioning, see *Merrimack National Bank* v. *Bailey, supra,* 289 F. at 470; *Cardozo* v. *Brooklyn Trust Co.,* 228 F. 333, 334 (2 Cir. 1915); that the deposits were unusual in the course of dealings between Oakland and the bank; and that Brede intended the deposits to serve as payment of his company's indebtedness to the bank. The bank's contention that the intent of the depositor is irrelevant misses the point.[8] If all six elements

8. The Supreme Court has recognized the significance of the intent of a depositor in making deposits which later are challenged as preferences. See *Mechanics' and Metals National Bank* v. *Ernst,* 231 U.S. 60, 67 (1913); *Studley* v. *Boylston National Bank, supra,* 229 U.S. at 526, 527, 529. In *Cusick* v. *Second National Bank, supra,* 115 F.2d at 152, the court stated that a deposit may be a preferential transfer if "either the [depositor] or the Bank, at the time of the deposits, intended them to operate as a payment of the notes . . . ." The rule as stated in *Cusick* was reaffirmed in *Mayo* v. *Pioneer & Trust Co., supra,* 270 F.2d at 836.

The question of the true nature of deposits calls to mind the query whether there is a sound when a tree falls in a forest (of oak[es] or

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of a preference under §60(a) exist, a preference will be found despite lack of intent on the part of the bankrupt to effect a preference. Here, the intent of the depositor is relevant in proving one element of a §60(a) preference—that the deposits were transfers—by showing that Brede never intended to withdraw the funds. If a depositor fully intends to leave the deposits in the account, available for set-off, they constitute payments on account of an antecedent debt whether or not at the time the deposits are made the bank knows it.[9]

just timbers) with no one near enough to hear it. Fortunately the purposes of the Bankruptcy Act point to the practical conclusion that when a depositor intends not to withdraw deposits those deposits should be treated as transfers for purposes of §60(a). The trustee, of course, must prove such a state of affairs or of mind, just as he must prove the existence of each of the other statutory elements of a preference. See *Farmers Bank* v. *Julian, supra,* 383 F.2d at 324.

9. The bank's insistence here that there can be no transfer unless the bank is implicated in or aware of the build-up confounds the separate distinct requirements of §60(a) and §60(b). These sections have different elements because they have different functions in the scheme of the Act: both are concerned with a preference, but "[s]ubdivision (a) defines what shall constitute it and subdivision (b) states a consequence of it—gives a remedy against it." *Pirie* v. *Chicago Title & Trust Co., supra,* 182 U.S. at 446. Knowledge or notice on the part of the recipient of an alleged preferential transfer is an element of §60(b), see note 1 *supra,* but not of §60(b). *Pirie, supra,* 182 U.S. at 446.

Matters v. *Manufacturers' Trust Co.,* 54 F.2d 1010 (2 Cir. 1931), is not to the contrary. There, in holding a bank deposit to be a preference under N.Y. Stock Corporation Law §15, Judge Learned Hand stated that the New York statute differed from the federal Bankruptcy Act in that the latter "charge[s] the transferee only when in privity with the transferor; . . . if there is to be a recovery, the bank must understand that the account is being built up so as to be available at the proper time for seizure." *Id.* at 1013. Aside from the fact that this statement was dictum since the holding was based on

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III.

We have considered the bank's other arguments and find them to be without merit.[10]

New York law alone and not on §60 of the Bankruptcy Act, the interpretation of the federal law is consistent with what we hold here. The knowledge to which Judge Hand adverted was the "reasonable cause to believe" requirement of §60(b), which then was phrased to require that the transferee "have reasonable cause to believe that the . . . transfer would effect a preference." Bankruptcy Act §60(b), as amended June 25, 1910, 36 Stat. 842. This is confirmed by Judge Hand's citation to *Kolkman* v. *Manufacturers' Trust Co.,* 27 F.2d 659 (2 Cir. 1928), another case under N.Y. Stock Corporation Law §15, where the Court held the innocence of the bank to be irrelevant under §15. The innocence of the bank was described in terms which indicated that the Court had in mind the "reasonable cause to believe" standard of §60(b): "[The insolvent's check] was received in regular course of business . . ., the bank acting throughout in good faith and without knowledge of the financial difficulties of its depositor." *Id.* at 660.

Furthermore, Judge Hand's comments in *Matters* assumed that the deposit was one "over which the depositor means to keep full control". 54 F.2d at 1013. In such a case, as we have discussed above, the only practical way to prove that the deposits were outside the regular course of business is to prove that "the bank must understand that the account is being built up so as to be available at the proper time for seizure." *Id.*

10. For example, whether the bank had reasonable cause to believe that Oakland was insolvent is something that the trustee must prove at trial and is a question for the jury.

The bank also contends that it was Brede, not the bank, who received a preference. Even if Brede as guarantor of Oakland's note received a preference, that does not necessarily preclude a finding that the bank received one. In *Citizens' National Bank of Gastonia* v. *Lineberger, supra,* and in *Joseph F. Hughes & Co.* v. *Machen, supra,* the Fourth Circuit held that there had been no "transfer" to the banks because the deposits had been made and accepted in the regular course of business. The court reasoned, a fortiori, that there had been no preferential transfers to the guarantors of the depositors' notes. The court responded to the trustees' arguments that there had been preferences to the guarantors by saying that perhaps that would be the case if the funds had been deposited in the accounts with the intent to effect a preference. These cases do not hold that in such a situation the banks would not have received preferences. In the instant case, the trustee is entitled to prove, if he can, that the bank and Brede have been preferred and have diminished the assets of the bankrupt's estate, to the detriment of the other creditors.

Nothing in this opinion is intended to express or imply any views on the part of the Court with respect to the result to be reached by the district court on remand. All we hold is that the trustee is entitled to his day in court and an opportunity to prove, if he can, a preferential transfer under §60 of the Bankruptcy Act in accordance with the correct legal standard as stated in this opinion.

Reversed and remanded for trial.

VAN GRAAFEILAND, *Circuit Judge*, concurring in part and dissenting in part:

I concur with the majority that the granting of summary judgment was error and that this matter must be remanded for a full development of the facts on trial. However, I cannot agree with the majority's exposition of the law to be applied by the district court on remand.

The issue in this case is a simple one: *viz.*, were the deposits by Oakland in its checking account "transfers" within the meaning of §1(30) of the Bankruptcy Act? 11 U.S.C. §1(30). The majority holds that a unilateral decision by a depositor not to exercise his right to draw checks against his account transforms the bank, without its knowledge, from a debtor to a transferee.[1] This does not accord with the "traditional rule" which is correctly set forth at the outset of the majority opinion; *i.e.*, "that in order to prove a voidable preference the trustee must show complicity or understanding on the part of the bank."

1. The majority does not state whether the depositor can "untransfer" the transferred funds if he changes his mind and decides to draw checks against his account.

In the leading case of *New York County National Bank* v. *Massey,* 192 U.S. 138, 147 (1904), the Court held that "a deposit of money to one's credit in a bank does not operate to diminish the estate of the depositor, for when he parts with the money he creates at the same time, on the part of the bank, an obligation to pay the amount of the deposit as soon as the depositor may see fit to draw a check against it." Until the bank acts to restrict the right of the depositor to write checks against the account, the money on deposit remains the property of the depositor and he may draw against it. *United States* v. *Sterling National Bank & Trust Co.,* 494 F.2d 919, 922 (2d Cir. 1974).

The *Massey* court held that in the absence of a showing of fraud or collusion between the bankrupt and the bank aimed at creating a preferential transfer of the bankrupt's property, the deposits which he makes create an indebtedness on the part of the bank and do not diminish the bankrupt's estate. This holding requires, at the least, that there be some participation or understanding on the part of the bank before an ordinary deposit can be considered a transfer, and this is the generally accepted rule. 4 *Collier on Bankruptcy,* § 68.16 at 919-21; 3 *Remington on Bankruptcy* § 1474.4 at 472 (J. Henderson rev. 1957). We have accordingly stated that where a bank accepts a deposit with the intention of applying it on a preexisting claim against the depositor rather than holding it subject to his right of withdrawal, there may be a voidable preference. *See Miller* v. *Wells Fargo Bank International Corp.,* 540 F.2d 548, 557 (2d Cir. 1976), (citing *Goldstein* v.

Franklin Square National Bank, 107 F.2d 393, 394 (2d Cir. 1939)). The test, as set forth in *Goldstein,* is whether the bank, in receiving the deposits, intends to apply them in payment or setoff of an outstanding indebtedness of the depositor. Expressed another way, the test is "[w]as the account of the bankrupt built up, with the understanding of the Bank, for the purpose of allowing the Bank to use it as an offset and thereby obtain a preference?" *Farmers Bank* v. *Julian,* 383 F.2d 314, 324 (8th Cir.), *cert. denied,* 389 U.S. 1021 (1967).

Although the majority's attempt to do equity will penalize only the bank in the instant case, the burden of the rule which we now lay down will fall in the long run upon the depositor. A bank is not simply a repository of funds; it is a source of credit. The facts of financial life are such, however, that the businessman seeking credit is most likely to secure it at the bank where he is a depositor. H. Justman, *Comments on the Bank's Right of Setoff under the Proposed Bankruptcy Act of 1973,* 31 *Bus. Law.,* 1607, 1611, & 1616 n.54 (1976). This bank not only has the use of the deposited funds; it also has the right of setoff. *Jensen* v. *State Bank,* 518 F.2d 1, 4 n.6 (8th Cir. 1975). The maintenance of an adequate balance in his demand account benefits the depositor as well as the bank, because the bank's right of setoff encourages it to continue credit when it might be induced otherwise to call its loans. If a businessman's efforts to create and maintain an adequate balance are, standing alone, to be construed as transfers of the funds involved, an inducement for the bank to work along with the financially troubled entrepreneur is removed. It

was to encourage such cooperation that the bank's right of setoff was preserved when the Bankruptcy Law was amended by the Chandler Act in 1938. *See* 4 *Collier on Bankruptcy,* §68.01(3). A right which Congress has refused to eliminate should not be eliminated by this Court in its stead.

I see no reason why the district court should be directed to depart from the rule laid down by this Court in *Goldstein, supra,* and approved only last year in *Miller, supra.*

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Memorandum and Order of District Court

(Filed October 22, 1976)

Pratt, J.

On June 30, 1971, defendant bank exercised its right of set-off against a checking account having a balance in favor of Oakland Foundry of Belleville, Illinois, Inc. in the amount of $108,783.91. These funds were applied against Oakland's indebtedness to the bank in the amount of $125,000. Fifteen days later, on July 15, 1971, an involuntary petition in bankruptcy was filed against Oakland in the United States District Court for the Eastern District of Illinois. Plaintiff seeks to invalidate that set-off as a voidable preference under 11 USC §96.

The following facts are undisputed, having been expressly asserted by defendant for purposes of the motion under local rule 9(g) and expressly admitted by plaintiff in his answering papers:

> 1. On or about January 16, 1969, in consideration of a loan from the Bank in the amount of $125,000, Oakland Foundry of Belleville, Illinois, Inc. ("Oakland") executed a promissory note in favor of the Bank for the sum of $125,000. The promissory note matured on April 16, 1969 and was thereafter renewed quarterly until June 18, 1970, when Oakland's obligation was made payable on demand. Affidavit of Anthony D. Famighetti, ¶2, Exhibit A ("Affidavit"), sworn to June 23, 1976.
>
> 2. Electronic Cabinets, Inc., Herman Brede and his wife, Betty D. Brede, guaranteed Oakland's indebtedness to the Bank. Affidavit, Exhibit B. The Bank ordinarily required a personal guaranty on a corporate

> borrowing by a small, individually held corporation such as Oakland. Without a personal guaranty, the Bank would not have made the loan to Oakland. Affidavit, ¶3.
>
> 3. In addition, Oakland secured its indebtedness and the guarantors secured their obligation by pledging with the Bank all of the stock of Electronic Cabinets, Inc. and H. W. Brede Co., Inc. Affidavit ¶4; Transcript of Testimony of Herman W. Brede, October 12, 1971 ("Brede Testimony"), at 7.
>
> 4. Oakland was a wholly-owned subsidiary of Electronic Cabinets, Inc., and Mr. and Mrs. Brede were the sole stockholders of Electronic Cabinets, Inc. and of H. W. Brede Co., Inc. Brede Testimony at 14-15. Mr. Brede was the president and chief executive officer of Oakland. Brede Testimony, at 5.
>
> 5. On June 18, 1970, at the time the parties converted Oakland's promissory note to a demand note, Mr. and Mrs. Brede gave the Bank additional security in the form of a second mortgage on their residence. Affidavit ¶6, Exhibit D.
>
> 6. At the time of the Bank's loan to Oakland, Oakland opened a general checking account with the Bank (the "Glen Head Account"). Affidavit, ¶7, Exhibits E and F. The Glen Head account was a general account, and there were no restrictions on Oakland's right to make withdrawals. Affidavit ¶7
>
> 7. Oakland maintained accounts at the St. Clair National Bank of Belleville, Illinois (the "St. Clair Account") and the Trade Bank & Trust Company of New York. Affidavit ¶8; Brede Testimony, at 8-9.

11. Oakland made deposits in the total amount of $47,738.56 in April of 1971, $48,105.05 in May of 1971, and $12,075.21 in June of 1971. Affidavit, Exhibit H.

12. In "June or July", Herman W. Brede, President of Oakland, telephoned Anthony D. Famighetti at the Bank in order to advise that Oakland was in "financial trouble". In that conversation, Mr. Brede stated that he "was going to talk to the other creditors to tell them that [he] was in trouble * * * [and] was still trying to work [his] way out of it." Brede Testimony, at 10-12.

13. The foregoing conversation between Mr. Brede and Mr. Famighetti, then the Bank's President (now Chairman of the Board and Chief Executive Officer), occurred on June 29, 1971. Affidavit ¶14, Exhibit I.

14. As a result of the conversation between Mr. Brede and Mr. Famighetti on June 29, 1971, the Bank, on June 30, 1971, set-off Oakland's funds in the Glen Head Account on June 30, 1971, which totalled $108,-783.91. These funds were applied against Oakland's indebtedness to the Bank in the amount of $125,000.00. Affidavit, ¶15, Exhibits J and K.

15. On July 15, 1971, an involuntary petition in bankruptcy was filed against Oakland in the United States District Court for the Eastern District of Illinois. Plaintiff's Answers to Defendant's Interrogatory No. 1. Subsequently, Oakland was adjudged bankrupt on August 18, 1971. Complaint, ¶5.

16. Donald Katz, the plaintiff herein, was appointed trustee in bankruptcy for the Oakland estate on or about October 12, 1971. Complaint, ¶5.

17. On October 12, 1971, counsel (now counsel to the trustee) for the receiver (now trustee) of the Oakland estate examined Mr. Brede, Oakland's President, in the bankruptcy court, under oath pursuant to Section 7a(10) of the Bankruptcy Act, 11 U.S.C. §25(10).

For purposes of this motion I have assumed that at the time of the set-off Oakland was insolvent and that the bank had reasonable grounds to believe that Oakland was insolvent. Since the set-off was by definition for the benefit of a creditor, the bank, on account of an antecedent debt, since it occurred within four months of bankruptcy, and since its effect enabled the bank to obtain a greater percentage of its debt than other creditors of the same class, it follows that all the elements of a voidable preference under §96 are present *if* the set-off itself constituted a "transfer" of Oakland's property.

The general law has been accurately summarized in 4 Collier on Bankruptcy §68.16 as follows:

> The general rule may first be stated that where an insolvent depositor makes general deposits within four months of his bankruptcy, which deposits are accepted in good faith and in the regular course of business, the bank has a right to setoff such deposits against an obligation owing to it by the depositor. Obviously, where the bank has no knowledge or imputation of knowledge, or "reasonable cause to believe", that the depositor is insolvent, such routine deposits are clearly available as set-offs. *But even though the depositor was insolvent and knowledge of this fact could be charged against the bank at the time when the deposit was made, the bank is still entitled to apply the deposit on its claim, so long as it was accepted in good faith, in the ordinary course of business.* It is only where affairs have reached such a point that the bank accepts

> the deposit for the purpose of payment, or of giving itself a subsequent advantage over other creditors through its right of set-off, or for some other special purpose, that the deposit and the subsequent application of it amounts to a recoverable preference. (At pp 917-920.1; emph. supp.)

A few pages later, discussing the requirement that the deposits be accepted in good faith and in the ordinary course of business, the author further states:

> The usual general deposits made on an open checking account subject to withdrawal at will constitute the type of deposits which will more often be considered above suspicion. But if the deposits are not accepted in the ordinary course of business, or are procured, accepted or "built-up" for the real purpose of permitting the bank to obtain a set-off, the deposits will be considered voidable preferential transfers and the right of set-off is lost. (At pp 923-925).

In *Jensen* v. *State Bank of Allison*, 518 F2d 1 (CA8 1975), bankruptcy trustee sought to vacate a set-off by the bank. As here, there was no evidence of the bank's complicity in a build-up of the depositor's account, or that the deposits had been accepted in order to permit the bank to obtain a preference. The account was one of long standing. The court noted that "[u]nder the Bankruptcy Act, no voidable preference is ordinarily created when a bank sets off funds in an account of general deposit with it against the debt owed it by the depositor". 518 F2d at 4.

In *Farmers Bank* v. *Julian*, 383 F2d 314, 325 (CA8 1967), the court stated:

> Section 68(a) of the Bankruptcy Act, 11 U.S.C. §108, applies and allows a setoff to [a] Bank unless the account has been accepted or built up for the real purpose of permitting the Bank to obtain a preference by way of setoff of the account. A bank account at the time of filing the petition in bankruptcy is a debt due to the bankrupt from the bank, and in the absence of fraud or collusion between the Bank and the bankrupt, the Bank may set the account off against any indebtedness owed it by the bankrupt. * * * The bank has the right to set off deposits against indebtedness even though the bankrupt is insolvent at the time of setoff and before the petition in bankruptcy is filed.

Further in *Farmers Bank* v. *Julian*, *supra*, the court stated the issue as follows:

> The issue is: Was the account of the bankrupt built up, *with the understanding of the Bank*, for the purpose of allowing the Bank to use it as an offset and thereby obtain a preference? 384 F2d at 324 emph. supp.

In the present case Herman Brede, President of Oakland, had personally guaranteed, together with his wife, the corporate obligations to the bank. From the fact that approximately $107,000 was deposited by Oakland in the general checking account in the bank, one might infer that Brede had intended to make those funds available for a set-off in the event of a bankruptcy. The key to the problem here, however, is that there is nothing presently in the record or which might be available to the plaintiff on a

trial to show any complicity by the bank in such an intention.

Insofar as the bank's actions are concerned, up until June 30, 1971, when its right of set-off was exercised, the funds which had been deposited by Oakland in its open checking account were available for withdrawal. There is nothing to show that the bank engaged in any collusion with Brede or Oakland, that it in any way isolated or liened the funds in Oakland's checking account, or treated the transactions in any way different from any other general checking account. Under such circumstances the bank had a right of set-off and its exercise thereof did not constitute a voidable preference.

Pinpointing the issue somewhat more narrowly, the cases seem to say that a bank's set-off of a general checking account will not constitute a viodable preference if the deposits were built-up or accepted in the regular course of business. The question arises: whose business? the bank's? or the depositor's? The trustee argues that this set-off must be voided if the deposits were not made by Oakland in the regular course of its business. I disagree, and for purposes of this motion, I have assumed that the deposits were *not* made by Oakland in the ordinary course of its business, but were instead made either to isolate funds from its Illinois creditors, or to place funds within easy reach of the bank's right of a set-off, which, if exercised, would reduce Brede's potential liability on his personal guarantee to the bank.

Such action by the depositor alone is not enough to constitute a voidable preference. The test is not whether the

deposits were made in the depositor's regular course of business, but instead, whether they were accepted by the bank in its regular course of business. Viewed in that light, there is nothing in the record by which the trustee could establish on a trial that these deposits were received by the bank in anything other than its ordinary course of business. The funds were kept available in the checking account, ready to be withdrawn any time up until the right of set-off was exercised.

Upon the oral argument plaintiff's attorney conceded that if on the law relief required the bank's involvement in the build-up of the account, and if there was nothing in the papers before the court to create a question of fact as to the bank's participation, collusion or complicity in a plan by Brede to prefer the bank over other creditors, then summary judgment would have to be granted to the defendant. I have reviewed the papers submitted on the motion, including both the affidavit and deposition of Anthony D. Famighetti, president of the bank, and conclude that neither anything in the papers nor in Mr. Famighetti's testimony raises any issue of fact on the key question.

None of the cases cited by plaintiff involves situations where a set-off was invalidated in the absence of evidence indicating that the bank had received the deposits in a manner not constituting the ordinary course of business. Since plaintiff has been able to produce no such evidence here and indeed has conceded that all the evidence available to him is presently before the court, no purpose would be served by permitting this case to go to trial.

Brede having disappeared, as noted by plaintiff's counsel on the argument, his testimony would not be available on a trial. Accordingly, summary judgment in favor of the defendant dismissing the complaint must be granted.

So Ordered.

Dated: Brooklyn, New York
October 19, 1976

/s/ George C. Pratt
U.S. District Judge